

**BellSouth's Response to
Audit of Continuing Property Records of
BellSouth Telecommunications As of July 31, 1997,**

On December 23, 1998, BellSouth received a copy of a Report of the Audit of the Continuing Property Records of BellSouth Telecommunications, Inc. as of July 31, 1997 ("Report"). Pursuant to a letter from Andrew Mulitz, Chief, Legal Branch, Accounting Safeguards Division, BellSouth provides this response to the Report. For ease of reference, BellSouth has followed the order of presentation of the issues set forth in the Report.

I. Executive Summary

BellSouth is extremely disappointed with the Report regarding BellSouth's Continuing Property Records ("CPR"). In response to the an initial draft report,¹ BellSouth pointed out numerous factual errors and flaws in the statistical sampling process utilized by the auditors. The final Report essentially ignores BellSouth's prior response. Indeed, the final Report contains new inconsistencies not present in the draft report.² BellSouth devotes substantial resources to ensure that its CPR is materially accurate and properly reflect the investment of BellSouth's assets. Moreover, BellSouth undergoes a financial audit each year by the independent accounting firm of PriceWaterhouseCoopers ("PWC"), which includes the BellSouth's fixed assets, and not once has there been any assertion of a material discrepancy in its fixed asset investment accounts. Accordingly, BellSouth stands ready to defend the accuracy of its investment accounts.

To understand the fundamental problem with the audit, one must first understand the audit's design. The audit was designed to test compliance with the minutia of rules established in Part 32.2000 *et seq.* and not the dollar value of the assets as recorded in the financial accounts, i.e., it was designed to test whether information such as location, identification number and quantity of the assets were recorded in the databases properly ("procedural compliance") and not whether the dollars attributed to each asset were accurately associated with the asset being used ("investment"). Thus, the auditors based their sample on a population of asset "line-items," not on investment dollars. In fact, the sample line items selected had no correlation to investment dollars.³ By using a process designed to test procedural compliance, the audit was a completely ineffective tool to predict error in the investment accounts with any degree of certainty.

The audit focused on two categories of fixed assets, Hard-Wired Equipment and Undetailed Investment. For the Hard-Wired Equipment, which makes up approximately \$8.8 billion out of a total \$38.8 billion of BellSouth Telecommunications, Inc.'s fixed assets, the

¹ An initial draft report of the audit was provided to BellSouth on July 27, 1998. BellSouth prepared a Response to the draft report and filed it with the Accounting Safeguards Division ("ASD") on August 26, 1998 (hereinafter "Draft Report").

² For example, in paragraph 32 of the Report, the auditors state that BellSouth has "over 252,700 records, nearly 29 percent of the records within the scope of this audit, are inaccurate or deficient in some respect." The auditors make this determination by including "all 83,900 Unallocated Other Costs" records as inaccurate or deficient. The Report specifically states in paragraph 4, however, that the auditors "are deferring final determination on the amounts associated with Unallocated Other Costs until sufficient documentation [is received] from the company." Consequently, the auditors have prejudged Unallocated Other Costs as deficient even before completing their work.

³ In other words, the auditors did not attempt to select assets with high dollar values.

auditors used a statistical sampling method to select the sample size and extrapolate errors over the population. For the Undetailed Investment, the auditors merely performed random tests over a small number of items, and did not base their sample or error extrapolation on any statistical basis.

A. Hard-Wired Equipment

1. Compliance with Part 32 Record Keeping Rules

As stated, the audit was designed to test compliance with procedural rules. Thus, for the Hard-Wired Equipment, the auditors used a statistical sampling method to select a sample of 1,152 line items from the CPR, out of a total population of 754,181, to test. The auditors' tests consisted of examining procedural information recorded for the assets as recorded in BellSouth's databases. Based on the result of the examination, the auditors "scored" the sampled item as either a 1 – found, 2 – found in another location, 3 – not found, or 4 – unverifiable. BellSouth disagrees with many of the scores that the auditors assigned to sample items. Many of these differences were caused by the auditors' inexperience with a very complex asset recording system. In response to the draft audit report, BellSouth documented the correct scoring for disputed items. However, the Report does not correct these scoring inaccuracies. BellSouth specifically identifies each scoring discrepancy herein.

2. BellSouth's Investment in Hard-Wired Equipment is Accurate

Once the auditors had completed their scoring for compliance purposes, they took the items scored as 3 – not found, and attempted to use these items to extrapolate a total dollar amount of missing investment. Because the audit was not designed to test investment, the extrapolation contains an unacceptably high margin of error. According to the Report, the investment for BellSouth's Hard-Wired Equipment is overstated by an estimate of \$291.7 million. However, the margin of error for their estimate is \$142.9 million, *49% of the estimate*. Thus, the auditors' own calculations estimate that the overstatement of investment, if any, could lie anywhere between \$148.8 million and \$434.6 million.⁴ Such an imprecise estimate is simply inadequate to justify an adjustment to BellSouth's recorded investment.

BellSouth employed the services of the international accounting and consulting firm Ernst & Young ("E&Y") to review the audit design and findings. E&Y conducted an extensive analysis of the draft report and concluded that in addition to the improper audit design, the auditors had: 1) failed to conduct a two-way audit, i.e., they only selected items from the records and traced them to the assets, they did not select an asset and trace it to the records; 2) used improper statistical calculations and therefore understated the margin of error in the estimate of missing investment; and 3) introduced bias into the sampling process.⁵ Based on these findings, E&Y concluded that "*the conclusions in the report concerning the amount of overstated investment are unsound and cannot be fairly relied upon.*"⁶

Based on the results of the auditors' own calculations, the further problems addressed in the E&Y Report, and the improper scoring demonstrated by BellSouth, the Report's conclusion that BellSouth's Hard-Wired Equipment investment is overstated by approximately \$291.7 million is unreliable and does not justify an adjustment to BellSouth's investment accounts.

⁴ This range is calculated as \$291.7 million \pm \$142.9 million.

⁵ A copy of E&Y's Report is attached as Exhibit I (hereinafter "E&Y Report").

⁶ E&Y Report at 7 (emphasis added).

3. Potential Regulatory Impact

The Report vaguely asserts that accurate plant account balances are used by policy makers “to evaluate financial results, regulated/non-regulated cost allocations, jurisdictional separations allocations, depreciation rates, initial prices, low-end earnings adjustments and productivity factors for price cap companies, and inputs for forward-looking cost models for calculating universal service support, interconnection agreements, and access charges.” While BellSouth certainly agrees that it is important to maintain accurate plant account balances, the use of the records that are the subject of this audit by regulators is minimal.

Even if the auditors’ estimate of missing investment were reliable, any write-off would have no impact on rates. A ratemaking impact would occur only if entries were made on the books reflecting the original cost of items that were not actually placed in service. The Report alleges no such conduct. To the contrary, the Report states: “For the purpose of this report, we assume the original costs recorded on its CPR are correct.” Thus, if any assets are listed in the Hard-Wired Equipment accounts CPR that are not in actual service, the only cause is a failure to properly retire the asset.⁷

Under the methods of accounting prescribed by the Commission in Part 32, the timing of the retirement of assets has no impact on the net investment used to set rates under rate of return regulation (which formed the basis for the initial price cap rates in 1990), and certainly has no impact on rates under price cap regulation (with or without sharing). This is so because when plant is retired, there are equal and offsetting entries to the telephone plant in service and accumulated depreciation accounts. “Net Plant,” the amount used to establish the rate base under cost of service regulation is unchanged. Thus, even if it could be demonstrated that BellSouth failed to retire certain assets on a timely basis prior to price cap regulation, the initial price cap rates would be unchanged. The same holds true for the application of the “sharing mechanism” or the “lower formula adjustment,” both vestiges of rate of return regulation, under price caps.⁸

Nor does retirement accounting materially affect cost models used to price BellSouth’s unbundled network elements, or its universal service support, which are based on forward looking economic costs, not historical costs. Forward-looking economic costs are not based on the company’s historical CPR.⁹

Finally, any impact on the depreciation expense would be negligible. While it is true that depreciation expense is calculated on gross plant, depreciation rates are based on net plant. Retirements would not change the net plant amount; however, the depreciation reserve percent, which is used in the calculation of depreciation rates, does change. The change in the reserve

⁷ In the Conclusions and Corrective Actions section, the Report states that “failure to provide sufficient and convincing documentation for the acquisition of the assets in question and for their placement into regulated accounts raises doubts about whether policy makers can rely on these records.” Report ¶ 36. Because the Report does not suggest or allude that any such documentation was not provided for the Hard-Wired Equipment, BellSouth assumes that this statement relates only to the Undetailed Investment account. Accordingly, BellSouth will address the statement below.

⁸ Financial results, regulated/nonregulated cost allocations, and jurisdictional separations are also based on “net plant.” Accordingly, any evaluation of these items would not be affected by the failure to retire assets.

⁹ The existing high cost fund, which does look at book costs, will not be used for non-rural local exchange carriers, like BellSouth, beyond 1999. See, discussion at Section VII, (1) and (2), *infra*.

percent would result in a higher depreciation rate being applied to a smaller gross plant amount. The higher depreciation rate would produce depreciation expense that is essentially the same as that already booked. Moreover, productivity factors for price cap carriers would only be effected if depreciation expense changed substantially.¹⁰ Because the depreciation expense impact is negligible there would be no impact on productivity factors. Under these circumstances, the Report provides no basis for a conclusion that BellSouth has at any time charged inflated rates.

B. Undetailed Investment

The Report recommends that BellSouth also “write-off” the entire amount in its Undetailed Investment account as of July 31, 1997, approximately \$138.5 million. The auditors reached this conclusion based on a random sample of line items at *three* central office locations, and by reviewing the cost support documentation for a random sample of 25 entries in the Undetailed Investment account. The Undetailed Investment account at that time was made up of over 21,800 line items. There is little doubt that even if no other problems were associated with their recommendation, a write-off of an entire account balance based on a few random samples is highly arbitrary and capricious.

BellSouth utilizes acceptable accounting practices, as defined in Part 32.2000, to account for the Undetailed portion of its investment. A portion of the account is made up of investment that was in place prior to the transformation from a manual CPR system to the mechanized CPR system. Pursuant to a ruling by the Commission, which was documented in BellSouth’s response to the draft report, this investment is allowed to be maintained in this account until it is retired. The remaining portion of this account is made up of investment dollars that BellSouth has spent, but has not assigned, or classified, to a specific property record item. BellSouth maintains this investment by Part 32 account, location, and vintage. The account essentially acts as a temporary cost holder for current investment during reclassifications. Thus, the amount of current investment in the account relates directly to the timing of any reclassifications in progress. As such, it is a valuable internal control tool in the accounting process. BellSouth provided the auditors with a complete explanation of the contents and accounting for the investment in this account in its response to the Draft Report, however, the auditors refused to acknowledge this explanation in the Final Report.

The Report alleges that BellSouth has “failed to substantiate the physical existence of equipment associated with Undetailed Investment line items or provide sufficient and convincing cost support for the related investment amounts shown in the CPR.” BellSouth feels that such statements are completely unjustified. Because the auditors do not agree with BellSouth’s accounting treatment for this investment is certainly no reason to question its physical existence.

C. CPR Rules and Requirements

The fact that the Commission would expend significant resources by both its staff and the audited carrier to assess compliance with archaic rules such as the CPR requirements continues to puzzle BellSouth. In response to the Draft Report, BellSouth demonstrated that the record keeping requirements being audited had no impact on rates or ratepayers.

¹⁰ In the 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, Professor Frank Gallop of Boston University filed an affidavit, which is attached as Attachment B to USTA’s Comments, concluding that moderate changes in the depreciation rates have no impact on the productivity factor.

These rules were created at a time when the rates that large local exchange carriers, such as BellSouth, charged customers were determined under rate-of-return regulation. The Commission, however, abandoned rate-of-return regulation for price-cap regulation in 1990.¹¹ The significance of the change to price-cap regulation cannot be overstated. Under rate-of-return regulation policy makers made decisions, including the setting of rates, based on a carrier's costs. Price-cap regulation, however, focuses on prices a carrier may set for its services instead of the cost to provide the services.¹² The cost of the service is no longer the basis on which a price-cap carrier sets the price it charges a customer for a service.

Accordingly, the only issue that policy makers should have a remaining interest in is whether the investment for fixed assets is properly recorded. Compliance with the detailed record keeping requirements of Part 32.2000 *et seq.* is not needed for such a determination. Indeed, no carriers other than the large local exchange carriers have such onerous record keeping requirements.¹³ These rules no longer serve any useful purpose, but are vestiges of an outdated regulatory system. The final report makes no attempt to document any public interest impact served by these rules.

D. Recommendations Set Forth in the Report

The Report concludes by recommending that BellSouth: 1) "write off" a portion, \$291.7 million, of its Hard-Wired Equipment and all, \$138.5 million, of its Undetailed Investment, 2) engage an independent firm to perform an inventory of its entire COE, and 3) engage an independent auditor to review its practices, procedures, and controls for maintaining its CPR. The auditors make these recommendations on the belief that they are needed in order to improve the records of BellSouth. For the purposes discussed herein, these recommendations, as proposed, do not accomplish that goal.

Although BellSouth disagrees with the audit design, the procedures the auditors used and the results obtained, it does not disagree with the general goal of any audit, which is to improve upon its records. Indeed, BellSouth has never rejected constructive feedback that it believes to be correct and helpful in improving its operations. Accordingly, BellSouth offers these recommendations regarding the audit.

BellSouth Recommendation 1:

BellSouth contends that the third recommendation proposed above is actually where any discussion of recommendations should begin. BellSouth fully believes that its records accurately reflect the investment of all of its fixed asset accounts. A major part of this confidence is based upon the controls and procedures it has in place to record asset acquisitions and retirements. BellSouth recognizes that these controls and procedures are invaluable to ensure that investment is recorded properly. These controls and procedures are reviewed each year by PWC in connection with its annual financial audit. However, BellSouth agrees that having another review of its practices, procedures, and controls for maintaining its CPR performed by an independent auditor may be beneficial in achieving improved records. BellSouth therefore would agree to engage an independent auditor to perform this review in conjunction with its

¹¹ In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, CC Docket No. 87-313, 5 FCC Rcd 6786, 6792 ¶ 47 (1990) ("*Price Cap Order*").

¹² *Price Cap Order* ¶ 47.

¹³ See *Ex Parte*, filed July 15, 1998 in CC Docket No. 98-81 "Accounting Simplification in the Telecommunications Industry," prepared by Arthur Andersen LLP ("Arthur Andersen Report" or "Report") at 25-37.

other recommendations set forth below. Once the review of the practices, procedures, and controls is completed, BellSouth would implement any suggestions made by the independent auditor. BellSouth would also report to the Commission the results of the review and the steps BellSouth took to implement changes, if any.

BellSouth Recommendation 2:

As demonstrated throughout this Response, BellSouth is convinced that its investment accounts are materially accurate and that the Report's estimated amount of missing Hard-Wired Equipment is the result of an improperly designed audit. BellSouth contends that if the audit had been designed properly the results would have proven that its investment accounts are materially and fairly stated. Accordingly, BellSouth proposes to engage an independent firm to conduct a statistically valid sample based inventory and reconciliation of its entire COE. BellSouth contends that the results of this review will show that the issues raised in this Response caused the results derived by the staff auditors to be flawed. BellSouth will report to the Commission with the independent firm's findings.

In addition to its contention that the audit results are unreliable, BellSouth makes this recommendation in response to the auditors' recommendation that BellSouth should have an independent firm perform an inventory of its entire COE. BellSouth agrees that a complete inventory of assets is an important and necessary control to ensure that its records are continually improving and remain accurate. In fact, BellSouth currently employs an inventory and reconciliation process for both its COE Hard-Wired and Plug-In Equipment on a cycle basis.¹⁴ The inventory and reconciliation process is performed on one-eighth of the Hard-Wired Equipment each year. Thus, the entire Hard-Wired Equipment will be completely inventoried over an eight-year period.¹⁵ Additionally, certain high activity offices, as determined by each state, are inventoried and reconciled every eighteen months. For Plug-In equipment, BellSouth employs a statistical sampling method to determine the locations to inventory. The sampling method, probability proportional to size ("PPS"), concentrates on selecting locations with the greatest amount of Plug-In Equipment investment. Also, the five locations with the highest dollar value of investment are inventoried annually. BellSouth books all adjustments to reflect any discrepancies found during these inventories and reconciliations of the Hard-Wired and Plug-In Equipment.

Accordingly, BellSouth is in fact performing the second recommendation made by the auditors in a manner consistent with ordinary business practices. BellSouth maintains that this program combined with its other recommendations better achieve the general goal of the audit – improvement of BellSouth's records. For example, included in the review of its practices, procedures, and controls (BellSouth Recommendation 1, *supra*), BellSouth would engage the independent auditor to also review its practices and procedures for performing the inventories and reconciliations of its COE. BellSouth would implement procedures suggested by the independent auditors, if any, into the inventory process to ensure that the process is functioning properly. Moreover, BellSouth would agree to summarize any adjusting entries made and provide that material to the Commission.

The Report does not specify the time frame when the inventory proposed by the auditors in their second recommendation would have to be completed. BellSouth believes that its current

¹⁴ These inventory and reconciliation processes are performed by an independent firm or BellSouth personnel.

¹⁵ Each state establishes their own inventory schedule for the eight-year period, and randomly assigns central offices to a particular year ensuring that all offices are covered in the eight-year period.

cycle schedule is aggressive but does not cause a major disruption of normal business activities. Disruption of normal business activities should of course be an important consideration of any actions resulting from the audit, especially considering that the personnel and systems in question are instrumental to providing local service at a high quality. An inventory of the entire COE is a major undertaking. It requires experienced people, both external with the independent firm and internal, and thousands of work hours to complete. Thus, the personnel resources alone to complete such a task are confined and present significant limitations to accelerating the time of completion.¹⁶ Even if the external personnel were available to accelerate the timing, the need for internal personnel would be magnified and therefore disrupt business activities. Such disruption could lead to the types of errors that the inventory is attempting to correct. Moreover, any concern that the auditors may have about the present condition of the investment accounts while the inventories and reconciliations are going through their cycles would be alleviated by the results of the statistically valid sample based inventory and reconciliation discussed above.

The recommendations proposed by BellSouth above not only provide a better basis to achieve the goal of the staff audit, but also allow the Commission more efficient use of its resources. It is BellSouth's understanding that the Commission staff is planning to perform an audit of Plug-In Equipment as phase II of the current audit. As discussed in BellSouth's Recommendation 2, BellSouth's proposal includes engaging the independent firm to perform a statistically valid sample based inventory and reconciliation of the entire COE, including Plug-In Equipment. This would provide the Commission with a verification of the Plug-In Equipment by an independent firm and therefore obviate the need for the Commission staff to perform the audit.

BellSouth Recommendation 3:

Finally, in addition to the fact that the proposed write off in the Report's first recommendation is completely improper and should not be made,¹⁷ BellSouth's recommendations eliminate the need for any write off of the investment accounts whatever. The adjustments, if any, made as a result BellSouth's ongoing inventories and reconciliations will serve to correct any discrepancies in the investment balances in the COE. Moreover, despite the fact that the Undetailed Investment is properly recorded, BellSouth will agree to retire or detail all permanent investment that currently resides in the account. BellSouth will, however, continue to use the account as a temporary cost holder for current investment during reclassification.

In summary, BellSouth proposes the following recommendations:

¹⁶ The cost of an inventory obviously increases in proportion to the time of acceleration. Thus, the cost could be astronomical depending upon the time frame requested. This, of course, presumes that enough trained personnel exist to perform the inventory in the time frame requested.

¹⁷ This impropriety is even more evident when carried to its practical conclusion. A "write off" of a fixed asset investment account requires the reduction, or credit, to the investment account. A corresponding reduction must be made to the detail records, in this case the CPR, because the detail records must reconcile to the investment account. Under the current situation there are no detail records because the proposed adjustment is based on an estimate and not a listing of known missing assets. If a "write off" is made only to the investment accounts, then a discrepancy will forever exist between the detail records of the CPR and the investment accounts.

1) BellSouth will engage an independent firm to perform a review of its practices, procedures, and controls for maintaining its CPR. As part of this review, BellSouth proposes to have the independent firm also review its procedures for conducting the inventories and reconciliations of its COE that it is currently performing.

2) BellSouth will retain an independent firm to perform a statistically valid sample based inventory and reconciliation of its entire COE. BellSouth will report the results of this review to the Commission. Additionally, BellSouth will continue its inventory and reconciliation process of its COE and will report these results to the Commission.

3) BellSouth will detail or retire all permanent investment in the Undetailed Investment account and only use the account to hold investment during reclassification.

Completion of BellSouth's recommendations will meet in the Commission's goal for improving the reliability of the COE investment accounts in a more constructive manner than the auditors' current recommendations. Thus, the Commission's acceptance of BellSouth's recommendations would obviate any need for an immediate adjustment to BellSouth's Hard-Wired Equipment based on the faulty results of the current audit or the launch of a staff audit of Plug-In Equipment. BellSouth believes its recommendations are both fair and adequate to eradicate any concerns the Commission may have regarding BellSouth's COE and effectively accomplish its goals.

II. Background

The Report provides a brief background on Part 32 accounting rules. All accounting rules that have been promulgated by the Commission speak for themselves. BellSouth reserves the right to challenge the interpretation of those rules contained in the Report.

A. Recordkeeping Requirements

The Report discusses the recordkeeping requirements set forth in the Commission's accounting rules codified at 32 C.F.R. §§ 2000, *et seq.* Once again, BellSouth reserves the right to challenge the auditors' interpretation of those rules.

BellSouth believes that the auditors have been unrealistic in their application of the rules in question. It appeared during the audit that the slightest deviation from the auditors' interpretation of a rule meant that BellSouth was found to be out of compliance. The standard for compliance with the rules cannot be absolute perfection. Rules that require absolute perfection are arbitrary and capricious and cannot form the basis for an enforcement action.¹⁸ Indeed, BellSouth challenges the Commission to find any organization with physical assets of equal size to BellSouth's that can claim perfection in its property accounting records. It cannot.¹⁹ The truth is, when a company has physical investment in Hard-Wired Equipment that exceeds \$8.7 billion, some mistakes will occur – it cannot be avoided. This does not mean, however, that the investment records are materially misstated. In fact, BellSouth contends that under a reasonable interpretation of the rules, its records are in excellent condition and accurate in all material respects. Thus, the standard of perfection may be quixotic, but it cannot and it should not be expected from BellSouth, or from any local exchange carrier, in its CPR.

¹⁸ AT&T v. FCC, 299 U.S. 232, 245 (1936) ("Penalties do not follow upon innocent mistakes.")

¹⁹ The property records of the Federal Government itself contain error rates comparable to those alleged in the Report. *See*, United States General Accounting Office, Report to Congress, Financial Audit 1997 Consolidated Financial Statements of the United States Government, March 1998.

B. 1994 Audit

The Report contains a section devoted to a 1994 audit of BellSouth's CPR. This section in the Report expresses concerns allegedly identified in the 1994 audit and even provides a summary of these alleged findings in an appendix. Specifically, the Report states that for the 1994 audit, the auditors selected a sample, based on the auditors' judgment and not on a statistical calculation, and performed verification procedures to determine if the sampled assets actually existed. Based on these procedures, the Report alleges that 15% of the assets sampled could not be found.

Additionally, without providing any specific details, the Report claims that attempts were made to "identify the assets associated with listings that did not contain adequate equipment descriptions." For such items, the Report claims "that [BellSouth] could not locate the assets and, generally, could not support its CPR values." The section concludes with the statement "[t]he audit staff discussed these concerns with [BellSouth] representatives during the course of the 1994 audit."²⁰

BellSouth denies the veracity of these allegations. To begin, no one from BellSouth was informed about the results of the 1994 audit. Indeed, the section in the draft report discussing the 1994 audit was the first comments BellSouth has seen regarding the audit since its conclusion. Moreover, these comments are inconsistent with the discussions the auditors held with BellSouth during the audit.

Two auditors, [name deleted] (lead auditor) and [name deleted], conducted the 1994 on-site audit. During the course of the audit, the auditors identified assets that they had trouble locating. For each of these assets, the auditors submitted to BellSouth a written data request for information that was needed to verify the existence of the asset. BellSouth provided complete and accurate information for all data requests submitted by the auditors. BellSouth was satisfied that all assets that were subject to the data requests were properly verified. The auditors gave no indication that the information provided did not answer all questions regarding the assets, and indicated that they accepted these data as full verification of the assets in question. Indeed, prior to the Report, BellSouth has received no notification that *any* asset tested could not be sufficiently verified by the auditors.

BellSouth is therefore dismayed by Section II.B, Page 5 of the Report. As discussed previously, although questions arose during the audit, there were never any discussions regarding the non-acceptance or non-compliance of BellSouth's cost verification or proof of any assets' existence. To the contrary, the auditors gave BellSouth the clear and distinct impression that BellSouth was in compliance with the Commission's CPR record keeping requirements, and, in fact, had the best records of any of the prior five carriers that had been audited. The auditors gave particular accolades to the Asset Management Group established in the network department for the control and identification of asset retirement units. The auditors commented that BellSouth was the only large LEC the auditors had examined that had established such an oversight group. Not once did the auditors allege unfavorable results for any one asset, much less that 15% of the sampled items could not be found.

²⁰ The Report also alleges that BellSouth "had not reconciled its CPR with its 1993 financial account balances." This reconciliation is time intensive. BellSouth routinely completes this reconciliation in April of the following year, i.e., the 1993 reconciliation would have been completed in April of 1994. Had the 1994 auditors requested to see the reconciliation, BellSouth would have provided it to them.

The comments in the Report are completely contrary to all previous contacts with the auditors regarding the 1994 audit. Section VI of the Report even declares that “we first became aware of the nature and scope of this problem during our 1994 audit of [BellSouth’s] CPR. That audit demonstrated that the problems were so pronounced and prevalent as to make it highly unlikely that the errors had developed in a relatively short period of time.” If the problems were “pronounced and prevalent” why were the problems not reported to BellSouth? The Report’s declaration that “informal discussions were held with each carrier regarding the problems found in their respective CPR,” is absolutely false in BellSouth’s case. In all informal discussions held between the auditors and BellSouth, not once did the auditors communicate a problem to BellSouth. Indeed, if the auditors had reported any audit problems that merited change, BellSouth would gladly have made such changes.

The Report includes an appendix summarizing the 1994 audit results. BellSouth unequivocally disputes every conclusion and finding in this appendix. Even if one assumed they were true, however, BellSouth believes it is inappropriate to not reveal the results until 4 years after the fact, and then, only in a report related to a subsequent audit instead of in a separate report. The lack of timely communication of the results of the 1994 audit is inappropriate on its face and highly disturbing in the light of the seriousness of the allegations the Commission has made in the Report.

One of the chief purposes of a Commission audit should be to inform the carrier of any problems encountered during the audit. This is particularly true if the Commission deems that the problems require corrective action on the carrier’s part. Absent such disclosure, how can the Commission expect the carrier to change the activity that the Commission considers to be improper? Many government agencies, including the General Accounting Office, follow Generally Accepted Government Auditing Standards (“GAGAS”) in conducting their audits. These standards state that the “auditors should prepare written reports communicating the results of each audit.”²¹ These standards also state that the report should be issued in order “to make the information available for timely use by management”²² Moreover, the standards state that the results of the audit should be first discussed with the appropriate management officials before the report is even issued.²³

Based on these facts, BellSouth objects to the Commission’s inclusion of any reference to the 1994 audit in the Report. Even if the results of the 1994 audit were not subject to challenge, these results were not reported to BellSouth in a timely manner. Inclusion of the 1994 audit results is intended to support allegations in paragraphs 31, 33, and 35 of long-standing irregularities in the accounting records that have not been corrected. The Commission, however, cannot expect BellSouth to correct any errors alleged in the 1994 audit when such errors were never reported to BellSouth.

²¹ Government Auditing Standards: 1994 Revision, issued by the United States General Accounting Office, Comptroller General of the United States (June 1994) (hereinafter “Yellow Book”) ¶ 7.2. *See also*, Generally Accepted Auditing Standards (“GAAS”) used by certified public accountants to audit the financial records of public companies as required by the Securities Exchange Commission. Four of the ten standards are dedicated to reporting the audit results. Frank C. Minter et al., *Handbook of Accounting and Auditing* § B1.06. (1998).

²² *Id.*, ¶ 7.6.

²³ *Id.*, ¶ 7.39.

III. Purpose and Scope

The Purpose and Scope section of the Report explains that while limited reviews were conducted on Plug-In Equipment, Plug-In Other Costs (“PIOC”), and Right-To-Use Fees (“RTUF”), the Hard-Wired COE and the Undetailed Investment and Unallocated Other Costs (“UOC”) were the main focus of the audit. The Report makes recommendations, however, only on Hard-Wired COE and Undetailed Investment.²⁴ Accordingly, BellSouth will limit its detailed comments to these two areas that are addressed in the Report.

BellSouth does note an inaccuracy in the Report regarding UOC, PIOC, RTUF, and Undetailed Investment. A review of the contents of these accounts will be helpful to the discussion. BellSouth discussed in the Executive Summary that Undetailed Investment is comprised of investment amounts that are held in this set of accounts pending being detailed and reclassified to their proper investment account.²⁵ UOC represents mismatch amounts between the investment in the CPR and the investment in the actual cost records (“ACR”) that comprise the official accounts maintained by the Finance department. These mismatches are generated during the reconciliation process for a given year under study. This reconciliation process is performed annually to align the investment amounts between the CPR and the ACR for the most recently closed fiscal year. RTUF represents capitalized amounts for the initial right-to-use fees at the time a switch is first placed in service. PIOC represents telephone company labor charges incurred for placement of plug-ins into service.

The Report states that “these four types of investment costs were not assigned to specific line-items of equipment in apparent violation of our rules. *See* 47 C.F.R. 32.2000(f)(2)(iii) and (f)(3)(i).” The rules do not require such assignment. BellSouth is in compliance with Part 32 regarding these items and questions whether the auditors properly considered whether BellSouth utilized an acceptable methodology in accounting for these costs. Specifically, PIOC and UOC are costs “associated with” property record items²⁶ maintained by location, vintage, class (plugs v. hard-wired) and Account/Field Reporting Code (“FRC”). These costs are not assigned to specific property record items, but are identified by a unique CPR number. Upon retirement of a property record item, a “reasonably accurate estimate of the plant retired can be determined.”²⁷ At such time a portion of the PIOC or UOC is retired along with the associated asset. The amount of UOC or PIOC retired is determined based on the relationship of the cost of material retired to the total cost of material for that location, FRC, and class of plant. This methodology of accounting for UOC and PIOC is perfectly consistent with Part 32.

RTU costs for the initial operating system are capitalized, along with the associated hard-wired equipment. All other software costs are expensed as incurred. These costs are assigned a unique CPR number and are carried in the same account, location, and vintage as the plant. Again, this is a perfectly acceptable method of accounting for these types of fees.²⁸

As the name implies, Undetailed Investment is composed of costs that have not been detailed to a specific investment account. These costs are made up of pre-1974 investment and current investment that is in the process of being classified. The pre-1974 investment is the

²⁴ The auditors concluded that additional tests were needed to audit Unallocated Other Costs and therefore have not included opinions or recommendations regarding these costs in the Report.

²⁵ *See*, Section V for further explanation of this set of accounts.

²⁶ *See*, 47 C.F.R. 32.2000(f)(3).

²⁷ *See*, 47 C.F.R. § 32.2000(f)(2)(iii).

²⁸ *See*, 47 C.F.R. 32.2000(f)(3).

result of the deployment of the automated CPR system in 1974. The plan to maintain pre-1974 as undetailed investment in this set of accounts was documented in M-295.²⁹ The Commission accepted M-295 pursuant to a letter dated December 24, 1968.³⁰ In addition, the Undetailed Investment acts as a temporary cost holder for current investment during reclassifications. As such, it is a valuable internal control tool in the accounting process. Thus, the amount of current investment in the account relates directly to the timing of any reclassifications in progress. Due to the length of time it takes to implement some of the assets and the complexity involved in classifying all costs associated with them, it would be unrealistic to expect BellSouth to do real-time classification of these assets. Accordingly, the amounts in this set of account are proper until the reclassification takes place.³¹

IV. Results for Hard-Wired Equipment

The draft correctly states that BellSouth representatives conducted an overview of the property record system and associated control processes, which is characterized very briefly. The following sections discuss certain weaknesses and shortcomings in the auditors' verification process and purported results.

A. Verification Process

BellSouth notes several issues that were not commented on in the Report. Due to the time limitations placed on the audit at each site and having no prior notice as to the specific items to be examined, the audit approach did not lend itself to a thorough on-site review. During BellSouth's own asset verification reviews, it is standard procedure to conduct research outside the inventory location and return to the inventory location on a subsequent visit to adequately ensure that the assets are being properly characterized as to their existence, identity, location, and quantity. This is especially true for the larger locations, where there are many thousands of line items and typically significant ongoing plant provisioning activities. The Report contends that items were only scored as not found when both the auditors and BellSouth personnel could not locate the equipment and, furthermore, when additional work (while at the site) did not allow the auditors to reasonably infer that particular equipment represented items initially viewed as missing. As related previously, the criteria for judging compliance with recordkeeping standards were unrealistically narrow. There were numerous occasions where lack of the part number being stenciled on the equipment or an inadequate understanding of supplemental items resulted in non-compliant findings when it could be reasonably concluded that the records were in compliance or the recorded item was located.

²⁹ M-295, Outline of Plan for a Mechanized Detailed Property Record of Central Office Equipment dated May 22, 1968. A copy of the M-295 Letter is attached as Exhibit II to BellSouth's Response to the Draft Report filed with the ASD on August 26, 1998.

³⁰ Letter from Mr. Kelley E. Griffith, Chief, Domestic Rates Division (for Chief, Common Carrier Bureau) to Mr. Alexander L. Scott AT&T's Vice President and Comptroller, dated December 24, 1968 (a copy of this letter is attached as Exhibit II). Undetailed investment represents investment related to years prior to the deployment of PICS/DCPR. In his letter Mr. Griffith recognized that "...you will have two continuing property-record plans for central office equipment, viz., the new plan and the continuation of the older type record and the method of operation thereunder, including determination of retirement amounts, for plant (other than capital tools and designated plug-in items) placed prior to adoption of the new plan." Additionally, the mechanics of the plan are such that details can be included in the record at any time for any previously undetailed amounts, if it becomes practicable to compile the details. See, M-295 Part I.1.08.

³¹ BellSouth explains the amounts in this set of accounts in Section V, below.

B. Records Examined

The auditors selected a sample of 1,152 records to test.³² The Report states that during the testing of these records the auditors “encountered numerous problems in [their] attempt[] to verify the sample.” The Report goes on to give details regarding the types of problems that were encountered and concludes that 215 line items had “serious problems.” BellSouth disputes the characterization of these line items as “serious problems” and further disputes the scoring the auditors assigned to these assets. BellSouth contends that many of the problems the auditors encountered were the results of their misunderstanding and misinterpretation of the structure of the basic data for the Detailed Continuing Property Record (“DCPR”) database and the supporting documentation relative to the recording of detailed hardwired equipment. This can be largely attributed to the large number of unique items in the DCPR, the potentially overlapping identification for some items, the different encoding interpretations applied by the numerous vendors supplying the equipment and associated DCPR load files, and the complex nature of how the investment is ascribed to the detailed property record items. BellSouth does not entirely fault the auditors because a significant amount of expertise and experience is needed to adequately interpret the varied permutations that can result from the presence of so many contingencies. BellSouth does note, however, that the audit teams were comprised of different persons and that this caused inconsistencies in the scoring of line items. This not only frustrated the audit process but caused the sampling results to be biased.³³

The Report also states that the auditors gave BellSouth a “draft report and requested that it provide comment on any factual errors or omissions contained in the draft audit report. On August 26, 1998, [BellSouth] submitted its response to the draft report. We reviewed [BellSouth’s] response and made appropriate adjustments as warranted.” BellSouth did provide a detailed response to the draft report, however, not one number in the Report differs from the numbers reported in the draft report.

C. Verification Results

As discussed in the Executive Summary, the audit was designed to test procedural compliance, but the auditors attempted to test both procedural compliance with the rules and the substantive investment in the financial records. To do this, the auditors tested each line item for procedural compliance and assigned it a score. The scores were categorized based on rating categories established by the auditors as: No. 1 - Item Found; No. 2 - Item Found at Another Location; No. 3 - Item Not Found; or No. 4 - Item Not Verified as Found.³⁴ In the Report the auditors then grouped the line items as scored for procedural purposes into categories to which

³² See, discussion of sampling method and process at Section IV. D.

³³ See, discussion of Bias at Section IV. D. (3).

³⁴ For the record, the definition for the scores or rating codes (1, 2, 3 & 4) has evolved or expanded with each succeeding phase of the audit. For example, during the site visits, BellSouth was told code 2 meant the item was found but with minor recordkeeping errors; then later, during an April meeting with the Commission audit staff to discuss BellSouth’s response to the preliminary scoring, BellSouth was informed that code 2 was more restrictive in that it meant an item found at another bay location. In this latest draft report, code 2 is defined as “Item(s) *matching the CPR description* found in another location (emphasis added),” which seems yet more restrictive. In another case, code 3 has evolved from “Item(s) not found” to “Item(s) not found or not found in sufficient quantity.” This has contributed significantly to BellSouth’s difficulty in developing consistent responses to the auditors’ results and explains potential mismatches in our current response.

they assigned investment values. The categories as provided in the Report are Assets Found (“AF”); Assets Partially Found (“APF”); No Assets Found (“NAF”); Unverifiable Assets (“UA”). From the APF and the NAF categories the auditors calculated the estimate for missing investment.³⁵

BellSouth disputes both the scoring the auditors assigned to the line items for procedural compliance and the categorization of the line items for investment purposes. For procedural compliance, BellSouth contends that the auditors did not have adequate time to obtain an understanding of the CPR system or to perform needed research on many of the line items to determine their proper score. This perpetuated itself in the investment categorization, as even more research would be needed to determine if a record error also had an investment impact. In many cases a record error, even for a line item listed as not found, will not correlate into an investment error.³⁶

BellSouth conducted exhaustive research on every line item the auditors tested and prepared its own scoring based on the results of the research performed. Almost all of this research has been provided to the auditors pursuant to their request and discussed in detail with the audit staff during a face-to-face meeting on April 7, 1998. This research was performed on both the procedural compliance of the records, and because the line items as scored by the auditors for procedural purposes were placed into categories used to calculate the estimate for missing investment, further research was performed to determine the investment impact, if any. BellSouth provides the following table that compares BellSouth’s and the auditors’ scores. The left portion of the table compares BellSouth’s scoring of line items to the auditors’ scoring of line items for investment purposes based on the categories listed in the Report. The right side of the table compares BellSouth’s scoring of line items for procedural purposes based on the categories established by the auditors.

Investment Categorization			Procedural Scoring		
Investment Rating Category From Report	Auditors’ Score	BellSouth Score	Procedural Compliance Scoring Category	Auditors’ Score	BellSouth Score
Assets Found	937	1051	1	937	981
Asset Partially Found	20	4			
No Assets Found	96	84			
Total Missing	116	88	3	116	84
			2	52	60
			4	47	27
Unverifiable Assets	99	13			
TOTAL	1,152	1,152	TOTAL	1,152	1,152

1. Procedural Compliance

BellSouth first addresses the differences noted in the above table in the procedural compliance scoring. BellSouth does not dispute the 937 items the auditors scored with a rating category No. 1. BellSouth asserts, however, that more of the items should have been scored under this category. The following is an explanation of BellSouth’s view of the records and how they should have been scored.

³⁵ See discussion of estimate calculations at Section IV. D.

³⁶ For example, the record error could have been an improper quantity input.

(a) Items Rated as Rating Category No. 2 by the Auditors

The auditors scored 52 of the test items in this rating category. BellSouth asserts that 60 of the items tested by the auditors should be scored to this rating category. BellSouth contends that 2 of the 52 items scored to this rating category by the auditors should be re-scored to rating category No. 1. BellSouth agrees with the auditors regarding the remaining 50 items they scored to this rating category.³⁷

Of the 2 items improperly scored to this rating category, one is associated with the aggregation of the former CPRs for power equipment (as defined in the national property record catalog) to the new locally defined CPRs. This was clearly documented in the information BellSouth provided to the auditors pursuant to their March 27, 1998 request and is referred to as the Power Roll-Up.³⁸ Specific supporting documentation particular to the line item was also included. The second line item was not originally located due to a lack of specific knowledge, by both BellSouth and the auditors, related to packet switching equipment. BellSouth later located the item. BellSouth experts in packet switching equipment re-visited the site and reviewed drawings to determine that the equipment exists and is properly recorded in the CPR.

(b) Items Rated as Rating Category No. 3 by the Auditors

The auditors scored 116 of the test items in this rating category. BellSouth asserts that only 84 of the items tested by the auditors should be scored to this rating category. BellSouth contends that 11 of the 116 items should be re-scored to rating category No. 1, 5 of the 116 items should be re-scored to rating category No. 2, and 16 of the 116 items should be re-scored to rating category No. 4.

Many of the items improperly scored to this rating category were not missing, but merely an incorrect quantity had been recorded in the records, or the investment was respread, sometimes in combination with the frame identification or quantity corrections or both.³⁹ Also, a number of the scoring differences are attributable either to the auditors' lack of understanding regarding the Power Roll-Up or a decision to ignore it and apply an improperly restrictive definition to item verification. Finally, various other circumstances resulted in improper scoring by the auditors including: 1) BellSouth's ability to locate item subsequent to the site review; 2) existing plug-in equipment incorrectly loaded as hardwired equipment in which case the item is reclassified as plug-in equipment along with the associated investment; 3) verification of

³⁷ BellSouth's result of 60 items is caused by a re-scoring of 5 items from rating category No. 3 and 5 items from rating category No. 4 to this rating category.

³⁸ The Power Roll-Up project fundamentally consolidated the many thousands of CPR identifiers for power equipment to 24 locally defined CPRs. This was accomplished through a software program that converted the current CPR identified in existing property records to one of the new CPR identifiers based on a detailed mapping table without altering the quantity, account, vintage or investment data. This results in many more manufactured items (part numbers) being identified with the same CPR. During the site visits, the auditors were using the national CPR catalog, which did not contain these locally defined CPRs, nor did BellSouth have all of the pertinent documentation at their immediate disposal in order to definitively link the found item with the new CPR.

³⁹ Respreading of investment is defined as a reattribution of the costs from one or more detailed line items to one or more detailed line items typically without altering the aggregate cost for each account and vintage within the location and certainly not altering the total aggregate cost at the location.

existence of one or more line items by demonstrating that the total aggregate number of all similar line items for the bay location or entire office, as the case may be, on the records agrees with physical total in the bay location or office; 4) record-only corrections to frame identifications; and 5) keying errors resulting in an incorrect CPR number assigned to the equipment in the records.⁴⁰

(c) Items Rated as Rating Category No. 4 by the Auditors

The auditors scored 47 items in this rating category. BellSouth asserts that only 27 of the items tested by the auditors should be scored to this rating category. BellSouth contends that 31 of the 47 items scored to this rating category by the auditors should be re-scored to rating category No. 1, and that 5 of the 47 items scored to this rating category should be re-scored to rating category No. 2. BellSouth agrees with the auditors regarding the remaining 11 items they scored to this rating category.⁴¹

Several items were improperly classified in this rating category because of the auditors' failure to acknowledge the results of the Power Roll-Up. Moreover, a few items were not stamped with a part number resulting in a highly judgmental evaluation based on a narrow definition by individuals with limited knowledge of telephone equipment as compared with BellSouth evaluators. Finally, various other reasons resulted in improper scoring by the auditors including: 1) legitimate item substitutions by vendors which were not properly reflected in the DCPR load file prepared by the vendors resulting in mismatches between physical equipment and property records; and 2) physical and record changes which occurred in the intervening time period from the data file being provided to the auditors up to the site visits, i.e., July 1997 through November 1997. This could include items removed from the office and the records through normal retirements, equipment additions, mechanized or manual reclassifications, and record corrections as a result of ongoing asset record verifications.

2. Investment

BellSouth also strongly disputes the auditors' categorization of line items for investment purposes as shown in the table above. As discussed previously, the auditors categorized the line items into the AF, NAF, UA, and APF categories for investment purposes merely based on the procedural compliance scoring. Determination of investment impact, however, requires extensive research the auditors did not do. BellSouth conducted research on each of the line items to determine if the item had an impact on investment regardless of whether any recordkeeping deficiencies had occurred. The auditors did not perform such an independent analysis to determine if there was any associated investment impact for the items that had recordkeeping errors. Based on this research BellSouth determined the following.

(a) Items Categorized as APF by the Auditors

The auditors' categorized 20 items as APF. BellSouth only places 4 items in this category. BellSouth asserts that 15 of the 20 items categorized as APF by the auditors should have been categorized as AF and 3 of the 20 should have been categorized as NAF. BellSouth

⁴⁰ In this case, verification cannot be adequately accomplished through physical inspection alone as one cannot determine if the mismatch between the item description and the equipment is due to the wrong equipment placed at the bay location or the result of the wrong CPR number having been assigned.

⁴¹ A re-scoring of 16 items from rating category No. 3 to this rating category causes BellSouth's result of 27 items.

concur with 2 of the 20 items the auditors categorized as APF. A re-categorization of 2 items from UA to APF caused BellSouth's result of 4 items in this category.

The majority of the items BellSouth revised to AF were the result of simple recordkeeping corrections to the quantity without any impact to the underlying investment. In some instances, in addition to quantity or frame identification corrections, a portion of the investment has been improperly ascribed these same line items and the costs have been respread, i.e., no investment dollars were retired but rather they were reallocated to other items in this same location. During its research BellSouth found three items to be missing in their entirety. Accordingly, it retired the full investment from the appropriate plant accounts.⁴²

(b) Items Categorized as NAF by the Auditors

The auditors scored 96 items as NAF. BellSouth contends that a total of 84 items should have been categorized to this rating category. BellSouth contends that 11 of the 96 items the auditors categorized to this category should have been placed in AF and 4 of the 96 items should have been placed in UA. BellSouth concurs with the auditors' assessment that 81 of the 96 items are in fact missing and properly assigned to this category. A re-categorization of 3 items from APF to NAF caused BellSouth's result of 84 items in this category.

The majority of the items BellSouth revised to AF were due to the reclassification from the Power Roll-Up, which was discussed in the procedural compliance section above. For other items reclassified as AF, the following occurrences are documented: 1) in one instance, BellSouth located an item subsequent to the site visit; 2) for other items a record-only frame identification correction was required; and 3) at the time of the audit there was a spare item on loan from one of the sites which has subsequently been returned to its home base. A CPR keying error and plug-in assets improperly identified to the hard-wired records and subsequently reclassified as plug-in equipment comprise the NAF changed to UA.⁴³

(c) Items Categorized as UA by the Auditors

The auditors categorized 99 items as UA. BellSouth contends that only 13 items should be in this category. BellSouth contends that 88 of the 99 items the auditors assigned to this category should have been placed in AF and 2 of the 99 items should have been placed in APF. BellSouth agrees with the auditors that 9 of the 99 items were properly placed in this category. A re-categorization of 4 items from NAF to UA caused BellSouth's result of 13 items in this category.

Two items were not found in sufficient quantity and it was also necessary for a portion of the investment to be retired from the appropriate plant accounts. There are 55 items rated as No. 2 for procedural purposes that should have been classified AF instead of UA, which is inherent in the criteria for No. 2. The remaining 33 items that BellSouth revised to AF resulted from various circumstances including: 1) association with the Power Roll-Up, 2) verification by aggregate quantity in office or frame identification equaling total number physically located in

⁴² The detail supporting each of BellSouth's categorization of APF items for investment purposes is set forth in Appendix 1 to BellSouth's Response to the Draft Report filed with the ASD on August 27, 1998.

⁴³ The detail supporting each of BellSouth's categorization of NAF items for investment purposes is set forth in Appendix 2 to BellSouth's Response to the Draft Report filed with the ASD on August 27, 1998.

office or frame identification, 3) record-only corrections to frame identifications, 4) record changes in process during audit time frame, and 5) miscoded CPR numbers.⁴⁴

As demonstrated, the differences in both the procedural scoring and the investment categorization used to calculate an estimate for alleged missing investment impact the auditors' findings greatly. In the next section BellSouth discusses problems in the sampling plan used by the auditors and also presents a calculation of the estimate of missing investment based on BellSouth's categorization of the line items.

D. Statistical Estimates Based on Sample

For purposes of brevity, BellSouth will not repeat the entire Report but will provide a brief synopsis of the auditors' statistical sampling design and results they reached.⁴⁵ The auditors determined the population for the sample to be the total number of line items, or records, in BellSouth's CPR. Applying the sample design, the auditors calculated a sample of 1,152 line items to test. These line items were tested pursuant to the procedures described in Section IV. B., *supra*. Based on the number of errors the auditors claimed to have found in the CPR, they projected two estimates. The first was an estimate of the proportion of the number of records or line items that did not comply with recordkeeping requirements. The second was an estimate of the dollar value of investment they contend is missing (or "not found") from BellSouth's plant assets. A standard error was computed for both estimates. The auditors then applied a standard distribution approximation for a 95% two-sided confidence level to both the line item and investment estimates to obtain confidence intervals for each estimate.

Applying this design to the auditors' sampling results for line items yielded an estimated number of line items that did not comply with recordkeeping requirements of 19.50% of the total population. The standard error for the line items was calculated to be .0153 which was multiplied by 1.96%, the multiplying factor to obtain a 95% confidence level under a standard distribution, to yield a margin of error of 2.99%. This corresponded to a confidence interval of 16.51 to 22.49 (19.50 \pm 2.99). Thus, the Report concludes that between 16.51% and 22.49% of the total line items do not comply with recordkeeping requirements.

Applying the design, and the auditors' sampling results, to the dollar investment of plant assets, the auditors estimated that \$291.7 million could not be located. The standard error for the dollar investment was calculated to be \$72.9 million which was multiplied by 1.96%, the multiplying factor, to obtain a 95% confidence level under a standard distribution, to yield a margin of error of \$142.9 million. This corresponded to a confidence interval of \$148.8 million to \$434.6 million (\$291.7 million \pm \$142.9 million). Thus, the Report concludes that the estimated missing plant lies between \$148.8 million and \$434.6 million. They chose the estimate of \$291.7 million as the amount of missing Hard-Wired Equipment that should be written off.

The conclusions reached by the Report are faulty because not only are the auditors' test results inaccurate (see discussions in IV.B., *supra*), but also the statistical sampling methods and sampling procedures were flawed. BellSouth retained the international accounting and

⁴⁴ The detail supporting each of BellSouth's categorization of APF items for investment purposes is set forth in Appendix 3 to BellSouth's Response to the Draft Report filed with the ASD on August 27, 1998.

⁴⁵ Section IV. D., and the accompanying Appendix B, of the Report describe in detail the statistical sampling design used by the auditors to calculate a sample of CPR to test for the audit. The auditors used the results of their tests to estimate an error in the records and in the investment accounts.

consulting firm of E&Y to conduct a review of the statistical sampling method⁴⁶ and the procedures the auditors used to calculate a sample and to extrapolate the results of their tests into their estimates of compliant records and missing dollar investment. Dr. Fritz Scheuren, a world-renowned statistician, directed this review.

As discussed above, the auditors' statistical sampling method was used to produce the results for both the recordkeeping requirements and the dollar investment. E&Y noted that the design employed by the auditors could be used to calculate estimates of many different types of population quantities. It was designed, however, to produce precise estimates for the proportion of compliant line items, not dollar investment. E&Y stated that "[I]n general, one can get reasonable precision for an estimate of proportion (as the audit report sought in [procedural compliance]) using many different sample designs. Estimates of total dollar values (such as sought [for the investment]) are far more complex and difficult. ... Thus, an experienced statistician faced with estimating a proportion and a total dollar amount, would usually plan the sample to obtain a relatively precise estimate for the total dollar amount, and accept the precision that is obtained for the proportion estimate. The methods identified in the [Report] did the exact opposite."⁴⁷ Accordingly, while the sample method could produce an acceptable degree of precision for the estimate for record compliance,⁴⁸ it contains major defects in producing an estimate with an acceptable degree of precision for the dollar investment. Accordingly, E&Y's report focuses on the problems associated with the \$291.7 million dollar investment estimate that the auditors contend should be written off.

E&Y determined that four major defects were inherent in the sample method and extrapolation procedures used for the dollar investment: (1) failure to conduct a two-way audit; (2) defective sample design; (3) bias; and (4) understated margin of error. These defects render the sample results unreliable and E&Y concludes that the sampling results cannot be fairly relied upon to support an investment adjustment.

1. Failure to Conduct a Two-Way Audit:

First, the auditors failed to conduct a two-way audit. The procedures used by the auditors only included selection of line items from the CPR and locating the physical asset associated with the line items. It did not include selecting a physical asset and locating the associated line item in the CPR. "If the intent of the audit was to attempt a quantification of 'missing' equipment, it would be necessary to conduct a two-way audit. ... The only way to determine 'missing' equipment would be to take the results of the initial audit and net them against results of the reverse direction audit. The failure to conduct the reverse audit here means that the FCC quantification of 'missing' investment systematically overstates the actual value and cannot be relied on."⁴⁹

⁴⁶ This included the review of the procedures the auditors used to pick the sample items and testing procedures when such procedures affected sampling results.

⁴⁷ E&Y Report at 3.

⁴⁸ While E&Y believed the design for record compliance to be acceptable, a margin of error of 2.99% was far from its desired effect. E&Y stated that the margin of error should be at most 0.25%.

⁴⁹ E&Y Report at 2.

2. Defective Sample Design:

“Second, the sample design was intended to measure the *proportion of items* not found. It was not intended to measure the *dollar value* of missing items.”⁵⁰ Because the auditors’ intent was to estimate a dollar value of missing investment, they should have designed the sample differently. The sample design is the “plan for choosing the way in which records are selected from the CPR database so that fairly precise estimates can be obtained.”⁵¹ This means “that the sample should be planned so that resulting confidence intervals will not be too wide with respect to the estimate.”⁵² The estimates calculated by the auditors, however, demonstrate that the sample design was incapable of achieving such results for dollar investment. E&Y concluded that the auditors’ estimated margin of error--approximately 49%--is far too imprecise to support an investment adjustment.

BellSouth finds it implausible that the Commission would consider an investment adjustment when so much uncertainty exists in the estimate. The Commission must recognize that a margin of error of 49% of the estimate clearly does not yield enough precision to form a rational basis for an adjustment. Moreover, the problem is exacerbated by the fact that the margin of error was mis-calculated by the auditors and is actually *understated* in the Report.⁵³

3. Bias

The third defect in the Report is bias associated with the sample. Bias can be both statistical and non-statistical. E&Y tested the statistical bias and found it to be negligible. E&Y, however, confirmed several forms of non-statistical bias. For example, “the audit staff did not use the same team of auditors to inspect each location.”⁵⁴ This caused significant differences in the scoring of line items depending on the audit team doing the scoring. E&Y was unable to determine if the auditors corrected the discrepancies between audit teams’ scoring through subsequent adjustments to the scoring process. None of the sites, however, were re-visited to confirm the true state of the property records.

Another form of non-statistical bias occurred in the sample selection process. If the auditors selected a location they subsequently concluded was impractical to audit, they simply selected another location to audit. This effectively removed locations from the audit sample. However, the Report draws conclusions for the entire population. Indeed, the auditors’ extrapolated their sample results over the entire population, making no adjustment for excluded locations. A reverse form of this bias was the inclusion of a central office from North Carolina. When the original sample size was selected, a central office from North Carolina was not included in the list of central offices to be tested. The auditors arbitrarily chose a location in North Carolina in order to have sample items from all of BellSouth’s states. This made the probability of selection for the North Carolina central office different from all the others in the stratum that it belonged to. This caused further bias in the estimate.

Moreover, E&Y noted that the auditors substituted for “hard-to-get-to” line items by using the preceding line item on the population list. E&Y suggests that because none of this bias

⁵⁰ *Id.* at 1.

⁵¹ *Id.* at 2.

⁵² *Id.*

⁵³ *See*, Section IV. D. (4) of this Response.

⁵⁴ E&Y Report at 4.

was accounted for during the audit, the auditors should have used a higher confidence level to calculate the margin of error. This concept is discussed below.

4. Understated Margin of Error:

The fourth defect recognized by E&Y in its report is that the margin of error, even at 49%, was understated in the Report results. As indicated above, “[t]he larger the margin of error, the less reliable the results.”⁵⁵ Little to no reliability can be placed on a 49% margin of error. When the Report results are modified to reflect the proper margin of error the results become even less reliable.

As discussed in the summary above, the auditors applied a standard (normal) distribution approximation, using a 95% two-sided confidence level, to obtain confidence intervals for the estimates. The sample size must be large enough to employ the standard distribution approximation in order to obtain the proper calculation for the confidence intervals. “The sample size used in the audit is not large enough to use the normal approximation. This leads the [Report] to systematically understate the margin of error in [the] dollar estimates.”⁵⁶ E&Y explains fully in its report why special statistical techniques must be used in such circumstances.⁵⁷ The audit staff did not use such techniques.

In addition to improperly using the normal approximation to calculate the confidence intervals, the auditors performed the confidence interval calculation using two-sided 95% confidence levels. This raised two concerns with E&Y. The first is that a 99% confidence level should be used instead of 95%. As recognized above, the audit is fraught with non-statistical bias. It is difficult to quantify these forms of error. Consequently, E&Y opined that it would be prudent to use a 99% confidence level to balance the bias that is inherent in the audit.

The second concern associated with the auditors’ confidence interval calculation is that it uses two-sided confidence levels or bounds. E&Y opined that the auditors should have used only a “lower confidence bound with a high confidence level – 99 percent.”⁵⁸ E&Y reported that the IRS always uses this lower bound approach in its audit findings. “In fact, the IRS calculates estimates in three ways. The method that produces the smallest margin of error is used, and the... lower confidence bound is the amount assessed.”⁵⁹

Prompted by these issues, E&Y, using the auditors’ own findings and correcting only for the calculation errors as discussed above, prepared its calculation of the margin of error. Because the normal approximation could not be used, E&Y used two advanced techniques to calculate confidence intervals. In the first technique, E&Y considered the “degrees of freedom” and used Student’s t distribution to find a multiplying factor. In the second technique they conducted a simulation experiment that estimated the total in-place cost of the population. From this simulation E&Y determined a multiplier. Both of these techniques are discussed in great detail in E&Y’s report.⁶⁰

⁵⁵ *Id.* at 3.

⁵⁶ *Id.*

⁵⁷ *Id.* at 3-4.

⁵⁸ *Id.* at 2 n.1.

⁵⁹ E&Y Report at 2 n.1.

⁶⁰ *See id.* Appendix A.

For the dollar investment, E&Y used the multiplier determined from the simulation, using a 99% one-sided confidence bound, to recalculate the auditors' results. Based on these recalculations E&Y concluded:

The estimate of BellSouth's total investment in error, using FCC scoring with partial credit, is \$291.5 million. The one-sided 99% lower confidence bound is negative \$32.6 million. Notice that the lower confidence bound goes beyond zero. This means that there is no statistically significant difference between the estimated total investment not found and zero.⁶¹

Thus, the proper margin of error and the appropriate confidence level used with the auditors' own sample findings⁶² yields an estimate so imprecise it cannot possibly be relied upon to make any form of an investment adjustment. An investment adjustment cannot be justified based on the results in the Report.

5. E&Y's Conclusions

Based on the work performed, E&Y concluded that "the estimates in the Report contain *biases*, and are *highly inaccurate* in other ways too. Given these errors and biases, the conclusions in the report concerning the amount of overstated investment are unsound and cannot be fairly relied upon."⁶³ Given this conclusion, the Commission has no basis to impose an adjustment to BellSouth's investment accounts based on the sampling results documented in the Report.

6. E&Y's Re-Calculation Using BellSouth Scoring and Categorization

BellSouth requested E&Y to prepare an estimate for missing investment based on the BellSouth's categorization of line items set forth in Section IV. C., *supra*. E&Y used all of the auditors' calculations except that the multiplier was calculated using the results of the simulation prepared in the E&Y Report. The results of the calculation yielded an estimate of \$147.9 million with a standard error of \$33.7 million. Applying the multiplier calculated from the simulation distribution for a 99% lower confidence bound yielded a lower bound of -\$2.0 million. Accordingly, using BellSouth's scoring and categorization, any estimate of missing investment is completely immaterial.

E. Examination of Cost Support Documents

In this section of the Report the auditors state that in order to test the documents to support the costs maintained in the CPR they requested "the cost documentation for a sample of 50 randomly selected hard-wired COE line items to be provided by March 27, 1998." On April 10, 1998, BellSouth hand delivered a binder containing responses to the 50 selected hard-wired COE line items to the Commission's audit staff. This response was followed-up on several occasions with an offer to visit the Commission audit staff to further explain and answer

⁶¹ E&Y Report at 3-4 (emphasis in original). The only change that E&Y's calculation makes from the Report is that E&Y corrected the margin of error based on the simulation results.

⁶² BellSouth disputes the auditors' findings, as discussed above; however, this conclusion is reached using the findings presented in the Report.

⁶³ E&Y Report at 6 (emphasis added). The auditors attempted to justify their results by performing a Bayesian analysis on the data from the audit sample. In its report, E&Y explains why the auditors' Bayesian analysis is misplaced. E&Y Report at 5-6 and Appendix C.

questions they may have on the cost verification data. This offer, however, was not accepted. Instead, a follow-up data request was received from the auditors dated June 3, 1998, which identified three line items from the original 50 line items on which “to provide a complete audit trail.” A response to this data request was provided to the auditors on July 7, 1998.

The Report does not address the accuracy of original costs, and for purposes of the Report the auditors assume that “the original costs recorded on [BellSouth’s] CPR are correct.” The auditors state that they will issue a separate report on this matter. Accordingly, BellSouth provides no further comment except to request that the auditors discuss any issues they may have regarding the cost documentation with BellSouth prior to issuing a report. BellSouth will continue to work closely with the audit staff and make every effort to be responsive to any necessary data request the audit staff needs to conduct its audit. BellSouth, however, requests that the Commission audit staff not underestimate the time, cost, and resources needed to comply with such data requests.

V. Results of Unspecified Items

A. Undetailed Investment

The Report makes many accusations regarding the amounts related to Undetailed Investment. These accusations appear to reflect the auditors’ misunderstanding of these accounts and the methodology BellSouth uses in accounting for them. The Report states that “the only specific explanation that [BellSouth] offered for these records is that they represent a portion of the investment installed prior to the implementation of its mechanized CPR,” (the pre-1974 investment). The amount of pre-1974 investment equals \$40.9 million of the total \$138.5 million in the Undetailed Investment accounts. As demonstrated by BellSouth in Section III, *supra*, this portion of Undetailed Investment is properly placed in these accounts. Until the assets associated with this investment are retired,⁶⁴ it would be improper to simply eliminate this amount from the records. Such action would result in telecommunications plant being recorded below original cost which is contrary to the accounting required by the Commission’s Part 32 accounting rules.

When the \$40.9 million of Undetailed Investment associated with pre-1974 investment is subtracted from the \$138.5 million, the amount in the Undetailed Investment as of July 1997, it leaves a remaining balance of \$97.6 million associated with current investments that are in the process of being detailed. BellSouth is currently reclassifying this amount to detailed investment. This is demonstrated by the fact that during the time period from July 1997 to March 1998 the amount of Undetailed Investment had decreased by \$25.5 million, approximately 18%, thus, leaving a balance of current investment to be detailed of \$72.1 million (\$97.6 million less \$25.5 million). This decline is expected to continue as ongoing work associated with investment reclassifications is completed. For example, due to an account reclassification now under way, \$34 million will be converted to detailed investment or be retired. The remaining \$38.1 million (\$72.1 million less \$34 million) represents only 0.2% of the total COE investment.

The amount in Undetailed Investment at any point in time is related to the timing of reclassification or the status of replacement of pre-1974 equipment. As previously discussed, the

⁶⁴ When a pre-1974 asset is retired from investment, a portion of the Undetailed Investment is allocated to the asset and also retired. Most of the pre-1974 assets are associated with analog equipment. Once BellSouth replaces its 1AESS switches, a significant portion of the pre-1974 analog assets will be retired or reclassified along with the associated portion of the Undetailed Investment.

detailing of these amounts is a laborious process; it cannot be done on a real-time basis. Any attempt to do so would result in confusion and improper classification. Moreover, if the entire amount were forced to be eliminated by a wholesale write-off, detailed investments would be understated.⁶⁵ Accordingly, BellSouth asserts that the amount in Undetailed Investment is properly stated.

To test this account the auditors attempted to look at Undetailed Investment at three locations they visited as part of the sample selected to test the Hard-Wired Equipment. The auditors then requested cost support documentation for 25 randomly selected entries listed in the Undetailed Investment. The Report concludes that the auditors were “unable to locate any of the Undetailed Investment during [the] on-site visits,” nor were they satisfied with cost support provided by BellSouth. Based on this unstatistical limited review of the Undetailed Investment, the Report questions the existence of all of the Undetailed Investment and recommends that it be removed from the CPR and the plant accounts.

As explained above, the nature of the account will not allow for the auditors to select a line item from the Undetailed Investment and trace it to a physical asset. The items in the Undetailed Investment are costs that must be assigned to a physical asset. The auditors failure to accept, or comprehend, the make up of this account is absolutely no reason to suggest a wholesale write off. Moreover, the Report’s claim that the auditors gave BellSouth the “opportunity ... to ... provide sufficient and convincing documentation supporting [Undetailed Investment]” is disingenuous. The opportunity to provide such documentation came in the form of “document requests” without opportunity to explain the information provided. This documentation is very complex and explanation is needed to understand how it supports the investment. The auditors’ failure to allow such explanation, and to then make recommendations that it be removed from BellSouth’s books and even to go so far as question the existence of the assets is grossly irresponsible. The auditors are fully aware that BellSouth’s controls and practices are such that it is virtually impossible for assets to be placed onto its books without being placed into service.

B. Unallocated Other Costs

The Report also discusses UOC. Because the Report defers opinion or recommendations to a subsequent report, BellSouth reserves comments on UOC except to restate its position that it has accounted for these costs appropriately, pursuant to the Commission’s rules. Moreover, BellSouth has provided responses for the 25 sample unallocated other line items requested by the auditors.⁶⁶

VI. Duration and Extent of the Problem

BellSouth is appalled by the auditors’ comments regarding the duration and extent of the alleged problems. As demonstrated in section II.B., *supra*, BellSouth received absolutely no indication from the 1994 audit that any problems existed in its CPR. Indeed, the first hint of a problem in the 1994 audit came in the Draft Report of this 1997 audit provided to BellSouth on July 26, 1998. BellSouth cannot be expected to correct alleged errors that it did not know

⁶⁵ The Summary section of the Report states that the estimate of non-located dollar investment, determined by the statistical sampling process, and the Undetailed Investment cannot be substantiated. The Report appears to recommend that BellSouth be forced to “write off” both of these amounts. As demonstrated here, and will be reiterated below, an arbitrary write-off the Undetailed Investment would be inappropriate.

⁶⁶ BellSouth submitted responses to the sample of 25 UOC line items as part of the six binders provided to the Audit Staff preceding the meeting held on April 7, 1998.

existed. Furthermore, it cannot be penalized in subsequent audits for failing to correct those alleged errors. The goal of any audit should be to inform and help the entity being audited to correct problems the auditors encounter, if any. The auditors cannot expect any positive results from the tactics practiced in the Report.

The auditors' irresponsible reporting of the amount of the alleged errors further offends BellSouth. In paragraph 32, the auditors allege that they estimate that "over 252,700 records, or nearly 29 percent of the records in the scope of this audit, are inaccurate or deficient in some material respect." They derive the 252,700 figure by adding 147,000 alleged record errors in Hard-Wired Equipment, 21,800 alleged record errors in Undetailed Equipment, and 83,900 alleged errors in Unallocated Other Costs. The Report specifically states, however, that the auditors are deferring final determination on Unallocated Other Costs until they have completed more investigation. This kind of irresponsible reporting only serves to further damage the credibility of the audit staff and its Report.

As to the remaining allegations in this section of the Report, BellSouth once again contends that the errors alleged by the auditors are not representative of BellSouth's CPR. Accordingly, any allegation that such errors are long-standing is improper.

VII. Conclusions and Corrective Actions

BellSouth takes great exception to the Report's conclusion that "[BellSouth] has not maintained its basic property records and its CPR in a manner consistent with the Commission's rules." BellSouth believes that its records are materially accurate and properly reflect its plant assets. BellSouth contends, as demonstrated throughout this Response, that the auditors' conclusions are based on an improperly designed audit and a misunderstanding of BellSouth's accounting methodology, which is proper pursuant to Part 32 rules, for accounting for a portion of its investment.

In paragraph 36 of the Report the auditors state that their audit results "raise[] significant questions about the valuation of [BellSouth's] plant accounts, its depreciation rates, and its past and present prices. At its worst, failure to provide sufficient and convincing documentation for the acquisition of the assets in question and for their placement into regulated accounts raises doubts about whether policymakers can rely on these records." BellSouth will address the latter of these accusations first.

It is completely irresponsible for the auditors to cast doubt on whether assets were actually acquired and placed in service. The Report specifically states that the auditors have not "completed their examination of the cost support documentation for the Hard-Wired Equipment and "for purposes of this Report, [the auditors] assume the original costs, [and therefore the acquisition of the assets,] recorded on its CPR are correct." Thus, if any assets are listed in the Hard-Wired Equipment accounts CPR that are not in actual service, the only cause is a failure to properly retire the asset. Accordingly, BellSouth assumes that the statement regarding doubts about the placement of assets into service relates only to the Undetailed Investment.

BellSouth explained in Section V.A., *supra*, however, that the Undetailed Investment can be fully substantiated and the issues associated with the account are based on differences in interpretation of the methods used to account for the investment. BellSouth believes that it is improper for the auditors to present even an implication that the assets may have not been placed in service. Consequently, the Commission should reject and remove any suggestion or allusion to such activity from the Report

The remaining allegation of paragraph 36 suggests that the audit results could impact plant accounts, depreciation rates and present and past pricing. However, even if one assumed

the audit results were accurate and that BellSouth had failed to make timely retirements from the plant accounts, none of the listed items would have been effected. For initial prices, under the methods of accounting prescribed by the Commission in Part 32, the timing of the retirement of assets has no impact on the net investment used to set rates under rate of return regulation (which formed the basis for the initial price cap rates in 1990), and certainly has no impact on rates under price cap regulation (with or without sharing). This is so because when plant is retired, there are equal and offsetting entries to the telephone plant in service and accumulated depreciation accounts. “Net Plant,” the amount used to establish the rate base under cost of service regulation is unchanged.⁶⁷ Thus, even if it could be demonstrated that BellSouth failed to retire certain assets on a timely basis prior to price cap regulation, the initial price cap rates would be unchanged. The same holds true for the application of the “sharing mechanism” or the “lower formula adjustment,” both vestiges of rate of return regulation, under price caps.

Nor does retirement accounting affect either the pricing of BellSouth’s unbundled network elements or universal service fund support under the methodology proposed by the Commission, which are based on forward looking economic costs, not historical costs. Forward-looking economic costs do not rely in any way on the accuracy of BellSouth’s CPR.⁶⁸ BellSouth’s access prices are constrained by the price cap plan, not book costs. To the extent the Commission looks at costs in relation to pricing new access services, the cost basis is “Net Plant,” which is unaffected by retirement accounting.

Finally, any impact on the depreciation expense would be negligible. While it is true that depreciation expense is calculated on gross plant, depreciation rates are based on net plant. Retirements would not change the net plant amount; however, the depreciation reserve percent, which is used in the calculation of depreciation rates, does change. The change in the reserve percent would result in a higher depreciation rate being applied to a smaller gross plant amount. The higher depreciation rate would produce depreciation expense that is essentially the same as that already booked. Moreover, productivity factors for price cap carriers would only be effected if depreciation expense changed materially.⁶⁹ Because the depreciation expense impact is negligible there would be no impact on productivity factors. Under these circumstances, the Report provides no basis for a conclusion that BellSouth has at any time charged inflated rates.

The Report also states that the detailed CPR “provide a key aspect of the audit trail for the plant accounts and facilities review, among other things, access charges, depreciation rates, and certain jurisdictional separations and other cost allocations.” Price-cap regulation, however, eliminated the need for such detailed record keeping requirements to protect consumers in the areas the Report lists. Comments filed in several recent biennial review dockets fully document this point. Moreover, the Arthur Andersen report referenced previously stated:

In a price cap environment ... such plant accounting detail is no longer of paramount importance as prices charged for regulated services are regulated instead of costs incurred and plant investment utilized to provide such services.

⁶⁷ This concept is discussed more thoroughly in Section VII.B., below.

⁶⁸ The existing high cost fund, which does look at book costs, will not be used for non-rural local exchange carriers, like BellSouth, beyond 1999. *See*, discussion at Section VII, (1) and (2), *infra*.

⁶⁹ In the 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent Local Exchange Carriers, CC Docket No. 98-137, Professor Frank Gallop of Boston University filed an affidavit, which is attached as Attachment B to USTA’s Comments, concluding that moderate changes in the depreciation rates have no impact on the productivity factor.

In the same manner, the detailed depreciation rate represetion process is no longer cost-beneficial, as costs no longer have a direct bearing on the determination of prices under price caps.⁷⁰

Accordingly, the Commission should abandon its myopic view of this regulation and follow the mandate of the 1996 Act for forbearance in this area.

A. The Proposed Write-Off of Equipment is Improper

The Conclusions and Corrective Actions section also discusses the auditors' recommendations that a portion of Hard-Wired Equipment and all of the Undetailed Investment be written off and that an inventory of BellSouth's entire COE be performed by an independent firm. Additionally, the Report recommends that BellSouth have an independent firm review the practices, procedures, and controls for maintaining its CPR. BellSouth will address the write off issue in the following paragraphs of this section and will address the recommendation regarding the taking of an inventory and internal control review in Section VIII of this Response. Paragraph 37 states that "[w]e believe that the amounts associated with Hard-Wired Equipment that was not found (\$291.7 million) and Undetailed Investment that could not be substantiated (\$138.5 million) should be written off [BellSouth's] plant accounts." The discussions above have explained in detail how many of the auditors' methods and procedures used in reaching these conclusions are flawed.

Defects and errors were pervasive throughout the statistical sampling method used by the auditors. This caused the estimate the auditors calculated for missing dollar investment to be highly inaccurate and unreliable. E&Y applied corrected statistical calculations to the auditors' test results and determined that there was no statistically significant difference between the correctly calculated estimated total investment not found and zero. Thus, any request that an adjustment be made based on the auditors' sample is entirely unjustified.

Moreover, even if the auditors' statistical sampling method were accepted without exception, their conclusions for the amount to be written off would likely be challenged in the professional accounting and statistical communities. For example, in determining the recommendation to write-off \$291.7 million for missing investment, the auditors stated that they "estimated the total missing plant cost to lie between \$148.8 million and \$434.6 million, with the most likely value for this cost centered around our best estimate of \$291.7 million." E&Y, however, states that "confidence intervals give a measure of the precision of the estimate, but no value contained within the interval is necessarily 'better' than any other. In a sense, values within an interval are statistically indistinguishable. Thus, a conservative approach is to use the lower bound of the interval." The recommendation that \$291.7 million be used as the adjustment, the estimate, instead of the lower interval of the auditors' range is unjustified.

Finally, BellSouth explained how many of the records the auditors scored as being noncompliant were actually in compliance. Moreover, in some cases, the auditors scored items as missing for compliance review, yet upon further research BellSouth determined that the compliance error did not have an impact on investment. The auditors, however, scored this as missing investment even though the asset was in existence. A mere record error is no basis to count an asset as missing and seek to have it adjusted out of the investment accounts. Investigation is needed to determine if it has an investment impact. Failure to investigate the investment impact, which caused the auditors to categorize items as missing for investment purposes, not only affected sampled items but also caused critical errors in extrapolating the results. This, of course, caused the estimate for missing investment to be significantly

⁷⁰ Arthur Andersen Report at 31.

overstated. Indeed, when E&Y ran the auditors' sample calculation using BellSouth's score for missing investment, the estimate was immaterial.

B. Any Proposed Write-Off would have No Impact from a GAAP or Regulatory Perspective

The proper application of Generally Accepted Accounting Principles ("GAAP") and the Commission's own rules regarding the retirement of telecommunications plant in service would not require an adjustment at all. For example, Conservatism does not support the proposed amount of the write off.⁷¹ BellSouth will demonstrate below that from the viewpoint of creditors and investors the alleged misstatement is immaterial. Additionally, retirement of plant investment accounted for and tracked using the group or mass asset methodology does not change the net investment, and hence the rates, which BellSouth charged under rate base rate of return regulation or under price caps with or without sharing. Because the accounting is the same for Part 32 and for GAAP, even assuming, arguendo, that the auditors' allegations of missing plant are valid, there would be no material financial or regulatory impacts resulting from the retirement of "not found" telecommunications plant in service.

1. Part 32 Accounting Rules

The pertinent sections of Part 32⁷² are abundantly clear that plant removed from a carrier's books must be accounted for as a retirement. The same accounting treatment is required under GAAP. Thus, even if management did determine that plant actually was missing, the proper accounting treatment would be to retire the plant by crediting the appropriate Part 32 plant accounts (i.e., 2xxx accounts) and debiting Account 3100, Accumulated Depreciation.

⁷¹ BellSouth is unsure what the auditors mean by recommending that the proposed amounts "should be written off [BellSouth's] plant accounts" as used in the Conclusions and Corrective Actions and Recommendations sections of the Report. Typically, write off refers to assets that are recorded, depreciated, tracked, and individually retired. BellSouth can only assume the auditors mean that any write off of investment should conform to the accounting for retirements prescribed by Part 32 and by GAAP, as discussed below.

⁷² Part 32.2000(d) provides the following guidance regarding the retirement of Telecommunications Plant:

"(d) Telecommunications plant retired. (1) Telecommunications plant accounts shall at all times disclose the original cost of all property in service. When any item of property subject to plant retirement accounting is worn out, lost, sold, destroyed, abandoned, surrendered upon lapse of title, becomes permanently unserviceable, is withdrawn or for any other reason is retired from service, the plant accounts applicable to that item shall be credited with the original cost of the plant retired whether replaced or not (except as provided for minor items in paragraph (d)(2)(ii) of this section)."

(d)(i)...For items included on the retirement units list, the original cost of any such items retired shall be credited to the plant account and charged to Account 3100, Accumulated Depreciation, whether or not replaced...."

Part 32.3100(c) provide the following guidance regarding the retirement of Telecommunications Plant:

(c) At the time of retirement of depreciable operating telecommunications plant, this account shall be charged with the original cost of the property retired plus the cost of removal and credited with the salvage value and any insurance proceeds recovered."

2. Regulatory Impacts

There are no regulatory impacts associated with the retirement of telecommunications plant. As the Commission knows, under the rate base rate of return paradigm, a significant component entering into the determination of rates was net plant. This component was determined by deducting the balance in Account 3100 Accumulated Depreciation from the balance in Account 2001 Telecommunications Plant in Service to arrive at the net telecommunications plant in service on which the carrier was allowed to earn the authorized rate of return. As the following table demonstrates, if plant were determined to be missing and the accounting prescribed by Part 32 is followed there is no change in net plant.

1997 (in billions)			
	Account 2001	Account 3100	Net Plant
As Report in ARMIS	\$47,203	\$24,155	\$23,048
Retire Plant	(292)	(292)	-0-
After Retirement of Alleged Missing Plant	\$46,911	\$23,863	\$23,048

There is no change in net plant regardless of what year the retirement occurred. Net plant is not changed because telecommunications plant and accumulated depreciation are both reduced by the amount of the plant retired. Thus, even if the alleged missing plant should have been retired, there would have been no impact on the rates paid by customers under either rate base rate of return regulation, the initial rates established under price cap with sharing or the rates established under price caps with no sharing paradigms.

3. Materiality

Even assuming arguendo that the auditors' estimate of \$291.7 million for missing investment is proper, BellSouth does not believe this to be a material amount when GAAP's materiality standard is appropriately applied. As of December 31, 1997, BellSouth had a balance of \$47.2 billion in Account 2001 Telecommunications Plant in Service, \$24.2 billion in Account 3100 Accumulated Depreciation and net telecommunications plant in service of \$23 billion. The \$291.7 million of alleged missing plant is .64% of the Account 2001 balance, 1.25% of the Account 3100 balance and 1.30% of net telecommunications plant in service. Moreover, the alleged missing plant is less than 1% of the balance in Account 2001 at December 31, 1990. It seems totally improbable that even the most stringent application of the materiality principle applied by an extremely conservative accounting professional would require a retirement of investment based on an extrapolation of this nature, especially considering that the estimate contains a 49% margin of error.

All of the above discussions assume that the alleged missing assets that the auditors recommend be written off are identifiable. Unless the assets are identified, no adjustment can be made to the CPR. If a write off is made only to the investment accounts, then a discrepancy will forever exist between the subsidiary records of the CPR and the investment accounts. Moreover, any recommendation for an adjustment to the investment accounts represents a distinct dichotomy between such an adjustment and the recommendation for an inventory of the entire COE.⁷³ If an inventory is performed, the results of the inventory will provide an accurate basis to adjust the CPR and the investment accounts. Accordingly, any adjustment made prior to the inventory would be premature.

⁷³ BellSouth discusses this recommendation in Section VIII.

VIII. Recommendations

The Report concludes by recommending that BellSouth: 1) “write off” a portion, \$291.7 million, of its Hard-Wired Equipment and all, \$138.5 million, of its Undetailed Investment, 2) engage an independent firm to perform an inventory of its entire COE, and 3) engage an independent auditor to review its practices, procedures, and controls for maintaining its CPR. The auditors make these recommendations on the belief that they are needed in order to improve the records of BellSouth. For the purposes discussed herein, these recommendations, as proposed, do not accomplish that goal.

Although BellSouth disagrees with the audit design, the procedures the auditors used and the results obtained, it does not disagree with the general goal of any audit, which is to improve upon its records. Indeed, BellSouth has never rejected constructive feedback that it believes to be correct and helpful in improving its operations. Accordingly, BellSouth offers these recommendations regarding the audit.

BellSouth Recommendation 1:

BellSouth contends that the third recommendation proposed above is actually where any discussion of recommendations should begin. BellSouth fully believes that its records accurately reflect the investment of all of its fixed asset accounts. A major part of this confidence is based upon the controls and procedures it has in place to record asset acquisitions and retirements. BellSouth recognizes that these controls and procedures are invaluable to ensure that investment is recorded properly. These controls and procedures are reviewed each year by PWC in connection with its annual financial audit. However, BellSouth agrees that having another review of its practices, procedures, and controls for maintaining its CPR performed by an independent auditor may be beneficial in achieving improved records. BellSouth therefore would agree to engage an independent auditor to perform this review in conjunction with its other recommendations set forth below. Once the review of the practices, procedures, and controls is completed, BellSouth would implement any suggestions made by the independent auditor. BellSouth would also report to the Commission the results of the review and the steps BellSouth took to implement changes, if any.

BellSouth Recommendation 2:

As demonstrated throughout this Response, BellSouth is convinced that its investment accounts are materially accurate and that the Report’s estimated amount of missing Hard-Wired Equipment is the result of an improperly designed audit. BellSouth contends that if the audit had been designed properly the results would have proven that its investment accounts are materially and fairly stated. Accordingly, BellSouth proposes to engage an independent firm to conduct a statistically valid sample based inventory and reconciliation of its entire COE. BellSouth contends that the results of this review will show that the issues raised in this Response caused the results derived by the staff auditors to be flawed. BellSouth will report to the Commission with the independent firm’s findings.

In addition to its contention that the audit results are unreliable, BellSouth makes this recommendation in response to the auditors’ recommendation that BellSouth should have an independent firm perform an inventory of its entire COE. BellSouth agrees that a complete inventory of assets is an important and necessary control to ensure that its records are continually improving and remain accurate. In fact, BellSouth currently employs an inventory and reconciliation process for both its COE Hard-Wired and Plug-In Equipment on a cycle basis.⁷⁴

⁷⁴ These inventory and reconciliation processes are performed by an independent firm or BellSouth personnel.

The inventory and reconciliation process is performed on one-eighth of the Hard-Wired Equipment each year. Thus, the entire Hard-Wired Equipment will be completely inventoried over an eight-year period.⁷⁵ Additionally, certain high activity offices, as determined by each state, are inventoried and reconciled every eighteen months. For Plug-In equipment, BellSouth employs a statistical sampling method to determine the locations to inventory. The sampling method, probability proportional to size (“PPS”), concentrates on selecting locations with the greatest amount of Plug-In Equipment investment. Also, the five locations with the highest dollar value of investment are inventoried annually. BellSouth books all adjustments to reflect any discrepancies found during these inventories and reconciliations of the Hard-Wired and Plug-In Equipment.

Accordingly, BellSouth is in fact performing the second recommendation made by the auditors in a manner consistent with ordinary business practices. BellSouth maintains that this program combined with its other recommendations better achieve the general goal of the audit – improvement of BellSouth’s records. For example, included in the review of its practices, procedures, and controls (BellSouth Recommendation 1, *supra*), BellSouth would engage the independent auditor to also review its practices and procedures for performing the inventories and reconciliations of its COE. BellSouth would implement procedures suggested by the independent auditors, if any, into the inventory process to ensure that the process is functioning properly. Moreover, BellSouth would agree to summarize any adjusting entries made and provide that material to the Commission.

The Report does not specify the time frame when the inventory proposed by the auditors in their second recommendation would have to be completed. BellSouth believes that its current cycle schedule is aggressive but does not cause a major disruption of normal business activities. Disruption of normal business activities should of course be an important consideration of any actions resulting from the audit, especially considering that the personnel and systems in question are instrumental to providing local service at a high quality. An inventory of the entire COE is a major undertaking. It requires experienced people, both external with the independent firm and internal, and thousands of work hours to complete. Thus, the personnel resources alone to complete such a task are confined and present significant limitations to accelerating the time of completion.⁷⁶ Even if the external personnel were available to accelerate the timing, the need for internal personnel would be magnified and therefore disrupt business activities. Such disruption could lead to the types of errors that the inventory is attempting to correct. Moreover, any concern that the auditors may have about the present condition of the investment accounts while the inventories and reconciliations are going through their cycles would be alleviated by the results of the statistically valid sample based inventory and reconciliation discussed above.

The recommendations proposed by BellSouth above not only provide a better basis to achieve the goal of the staff audit, but also allow the Commission more efficient use of its resources. It is BellSouth’s understanding that the Commission staff is planning to perform an audit of Plug-In Equipment as phase II of the current audit. As discussed in BellSouth’s Recommendation 2, BellSouth’s proposal includes engaging the independent firm to perform a statistically valid sample based inventory and reconciliation of the entire COE, including Plug-In Equipment. This would provide the Commission with a verification of the Plug-In Equipment

⁷⁵ Each state establishes their own inventory schedule for the eight-year period, and randomly assigns central offices to a particular year ensuring that all offices are covered in the eight-year period.

⁷⁶ The cost of an inventory obviously increases in proportion to the time of acceleration. Thus, the cost could be astronomical depending upon the time frame requested. This, of course, presumes that enough trained personnel exist to perform the inventory in the time frame requested.

by an independent firm and therefore obviate the need for the Commission staff to perform the audit.

BellSouth Recommendation 3:

Finally, in addition to the fact that the proposed write off in the Report's first recommendation is completely improper and should not be made,⁷⁷ BellSouth's recommendations eliminate the need for any write off of the investment accounts whatever. The adjustments, if any, made as a result BellSouth's ongoing inventories and reconciliations will serve to correct any discrepancies in the investment balances in the COE. Moreover, despite the fact that the Undetailed Investment is properly recorded, BellSouth will agree to retire or detail all permanent investment that currently resides in the account. BellSouth will, however, continue to use the account as a temporary cost holder for current investment during reclassification.

In summary, BellSouth proposes the following recommendations:

1) BellSouth will engage an independent firm to perform a review of its practices, procedures, and controls for maintaining its CPR. As part of this review, BellSouth proposes to have the independent firm also review its procedures for conducting the inventories and reconciliations of its COE that it is currently performing.

2) BellSouth will retain an independent firm to perform a statistically valid sample based inventory and reconciliation of its entire COE. BellSouth will report the results of this review to the Commission. Additionally, BellSouth will continue its inventory and reconciliation process of its COE and will report these results to the Commission.

3) BellSouth will detail or retire all permanent investment in the Undetailed Investment account and only use the account to hold investment during reclassification.

Completion of BellSouth's recommendations will meet the Commission's goal for improving the reliability of the COE investment accounts in a more constructive manner than the auditors' current recommendations. Thus, the Commission's acceptance of BellSouth's recommendations would obviate any need for an immediate adjustment to BellSouth's Hard-Wired Equipment based on the faulty results of the current audit or the launch of a staff audit of Plug-In Equipment. BellSouth believes its recommendations are both fair and adequate to eradicate any concerns the Commission may have regarding BellSouth's COE and effectively accomplish its goals.

⁷⁷ This impropriety is even more evident when carried to its practical conclusion. A "write off" of a fixed asset investment account requires the reduction, or credit, to the investment account. A corresponding reduction must be made to the detail records, in this case the CPR, because the detail records must reconcile to the investment account. Under the current situation there are no detail records because the proposed adjustment is based on an estimate and not a listing of known missing assets. If a "write off" is made only to the investment accounts, then a discrepancy will forever exist between the detail records of the CPR and the investment accounts.

Conclusion

In Summary, in calculating an estimate of overstatement in the investment, the auditors used a defective sampling method that severely affected the reliability of the auditors sampling results. E&Y concluded that based on its review of the sample results, using the Report's "own calculations without any corrections the evidence was very weak when making statements about total dollar amounts." Thus, even if every word in the Report were taken at face value, the results of the sample are so unreliable that any forced adjustment to BellSouth's financial records would be unwarranted. However, once the indisputable sampling defects are factored into the equation, any form of a forced adjustment would be arbitrary and capricious.

Moreover, BellSouth has demonstrated that many discrepancies exist between the results reached by the auditors and the results reached by BellSouth regarding the scoring and categorization of the line items tested during the audit. BellSouth has conducted extensive research to support its findings related to both the scoring of line items for procedural compliance and the categorization of line items for investment purposes. Based on this research BellSouth has demonstrated in this response that the auditors results are questionable at best, and cannot be relied upon for any definitive purpose of adjusting BellSouth's investment.

Faced with the evidence BellSouth has presented in this response, the Commission cannot simply parrot the auditors' findings and recommendations. It must carefully review all the information BellSouth has provided to the auditors and determine that an adjustment is not warranted. BellSouth believes that this audit should be closed with no enforcement action required.